

Fiscal Surveillance in EMU: New Issues and Challenges

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Contingent Liabilities in New Member States

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Why Contingent Liabilities Need to Be Taken into Account

Experience has suggested that governments, including those in New Member States, may be accumulating significant obligations in the form of contingent liabilities that are neither recorded nor analyzed in fiscal documents.¹ Perhaps none of the New Member States, and only few of the long-standing EU Members, have the institutional frameworks and capacities to effectively control and manage contingent liabilities. New Member states, however, have belonged to the countries perhaps most prone to the accumulation of contingent liabilities and related fiscal risk.

First, the high cost of transition and structural reforms has invited the creation of schemes that involve government contingent liabilities (which are either explicit or implicit as illustrated in Figure 1) and shift part of the cost into the future.

Second, the privatization of state functions driven by the fiscal constraint as well as by efficiency reasons (for instance in pensions and infrastructure) has demanded contingent government support, again either explicit or implicit, to entice private interest.

Third, as also the experience of the long-standing EU members can attest, the pursuit of deficit targets generates incentives for governments to favor off-budget forms of government support that do not require immediate cash and that, at least for some time, hide the underlying fiscal cost – while creating contingent liabilities. Similarly, the pursuit of fiscal adjustment and deficit targets may elevate the long-term fiscal risks as it complicates structural reforms in the social as well as enterprise sectors.

Finally, the growing developmental role and autonomy of local governments may be associated with the elevation of local government contingent liabilities and debt. Such local government obligations often represent either an explicit or implicit contingent liability for the national government.

¹ Contingent liabilities are obligations triggered by a discrete event that may or may not occur. International financial reporting standards define a contingent liability as (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the enterprise; or (b) a present obligation that arises from past events but is not recognized because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability (International Accounting Standards Board 2004).

Inasmuch markets in the New Member States are still “emerging”, in the sense of somewhat prone to failures, government contingent liabilities arise from explicit promises and implicit expectations of government help in case of a failure. Such expectations also give rise to moral hazard, which in turn exacerbates the fiscal risk.

Whether a result of fiscal opportunism to conceal the true fiscal cost of government programs, or of an effort to find more efficient ways to achieve policy objectives, or of lenience toward moral hazard in the behavior of market agents, often contingent liabilities have turned out to be very costly. At some point of time, many guarantees fall due, state insurance programs require subsidies, and banks involved in policy lending or exposed to excessive risk with the hope of government bail-out eventually file for such bail-out. International experience suggests that contingent liabilities tend to surface and require public resources particularly in times of economic slowdown.

Therefore a point can be made that both explicit and implicit contingent liabilities need to be fully considered in the EU fiscal surveillance framework. Although a number of improvements in reporting, accounting, budgeting and overall fiscal management has been achieved in New Member States in recent years, partly thanks to the initiatives led by international institutions like the European Commission, EUROSTAT, World Bank, IMF, INTOSAI, and OECD, revealing, assessing and addressing governments’ contingent liabilities and associated fiscal risks is far from easy. It is still a case in New Member States that a string of years when government has reported low budget deficit and debt levels suggests neither that the government has been fiscally prudent nor that it will enjoy fiscal stability in a near future.

The challenge is, of course, how best to capture contingent liabilities in the fiscal surveillance framework. The Commission, along with the World Bank, IMF and others, has already some experience in bringing contingent liabilities and related fiscal risk into the formal frameworks of fiscal analysis and country assistance.² A number of countries, including Canada, Colombia, Czech Republic, Netherlands, and the United States, have provided good examples of capturing at least selected contingent liabilities in the fiscal framework. In this context, several different analytical and institutional concepts have been

² European Commission (2004) and European Commission and World Bank (1998 and 2000).

developed and applied in recent years, namely the Fiscal Risk Matrix, the IMF Code of Fiscal Transparency, accounting, budgeting and provisioning for risk, and the balance sheet approach to fiscal management.³ Moreover, some countries, including Chile, Turkey and Sweden, have tried to deal with contingent liabilities with the help of sophisticated risk valuation methodologies. This paper draws lessons from this expanding range of experience.

Perhaps the main problem in fully including contingent liabilities in the fiscal surveillance framework is implementation. Effective implementation of fiscal surveillance with respect to contingent liabilities depends on the willingness of governments to expose relevant information. Contingent liabilities may arise in many different forms, involve different levels of government, and may not be detected until they fall due, and even then a bail-out might be orchestrated through a financial institution for instance rather than the government itself. Many contingent liabilities remain unknown unless the government exposes them at its own initiative. Some may not be even known to the government as a whole unless the government monitors all its possible sources of fiscal risk, including for instance contingent liabilities of local governments and state-owned utilities.

If the willingness of governments to cooperate in revealing contingent liabilities is important, then obviously incentives and enforcement matter. In effect, are countries rewarded for transparency or punished?

Some experience among New Member States suggests that countries may be punished at the time when they reveal contingent liabilities, but not punished at the time when hidden contingent liabilities fall due. For instance, in 1997, the Minister of Finance of the Czech Republic volunteered detailed information about until then unknown contingent liabilities arising from the so-called transformation institutions⁴ and off-budget funds. Meanwhile, these entities have been either dismantled or scheduled for dismantling, and brought under the Maastricht fiscal framework. From the moment when the Czech

³ International Accounting Standards Board (2004), Irwin (2003a), Brixi and Schick (2002), and Cassard and Folkerts-Landau (1997).

⁴ Transformation institutions had been created as off-budget agencies to borrow, issue guarantees and finance government support programs for banks, enterprises, and other entities. Some of transformation agencies were covered by an explicit government guarantee others not.

Ministry of Finance opened a public discussion about contingent liabilities, however, many international institutions along with sovereign credit rating agencies and others, have been expressing concern about contingent liabilities in the Czech Republic. Their focus was not on the fact that the Czech Republic has finally become determined to bring its contingent liabilities under control. Rather than commending on the formidable steps toward fiscal transparency and discipline, analysts rang the bells of warning.

Taking contingent liabilities into account in fiscal surveillance, the Commission may have the leverage to encourage disclosure and appropriate treatment of government contingent liabilities in New Member States.

What Are the Current Risk Exposures

Currently, there appear three main sources of contingent liabilities in the New Member States of the European Union.

First, some countries have used contingent liabilities to deal with the cost of transition and restructuring of the financial and enterprise sectors and/or privatization. For instance, privatization funds, explicitly or implicitly guaranteed by governments, have issued their own guarantees, mainly related to possible environmental liabilities, in several countries, including the Czech Republic and Hungary. In most New Member States, economic restructuring continues. The ongoing economic restructuring and privatization, for instance in Polish mining and railway sectors or Maltese shipyards, may generate contingent liabilities and fiscal risk for the state.

Second, more recently, New Member States have found contingent liabilities a useful instrument to facilitate the change in the role of the state. All of those New Member States who embarked on extensive pension reforms, namely Estonia, Hungary, Latvia, Poland, and Slovakia provided guarantees with respect to minimum pension benefit or minimum returns of pension funds as part of the reform package. While such guarantees may have been justified on both efficiency and equity grounds, they give rise to fiscal risk.

Many New Member States have been considering expanding the use of public-private partnerships as a way of bridging the infrastructure gap. Public-private

partnerships, however, tend to require government support through disguised subsidies, often in the form of explicit government guarantees or legally less binding letters of comfort issued by either the central or local governments. Experience so far, both around the world and in several New Member States (for instance, in Hungary's road sector and Poland's power sector), indicates that public private partnerships give rise to significant government contingent liabilities and fiscal risk. This problem is large mainly if the government agrees to bear any other risk than risk directly associated with its own policies.

Third, contingent liabilities may appear as part of the involvement of local governments in promoting regional/local development. To fulfill their growing responsibilities, local governments need to reach beyond their budgets. Most New Member States have established strict monitoring system with respect to local government borrowing. Contingent liabilities assumed by local governments, however, often remain outside these systems and may expose local governments, and ultimately also the central government, to fiscal risk.

Figure 1 below provides a snapshot of the current sources of fiscal risk, namely contingent and direct, both explicit and implicit, liabilities in New Member States. Many of these are mentioned, and some even assessed, in the Commission's study (2004) based on the countries' Convergence Programs.

Although not explicitly captured by ESA95, some contingent liabilities in the New Member States have entered the government fiscal framework under the Maastricht criteria as the countries have expanded their definition of general government. Bringing off-budget agencies in charge of financing quasi-fiscal activities into the general government has in essence redefined such agencies' liabilities from being contingent to becoming direct for the government.⁵

The Czech Republic and Slovakia have been the leaders in this respect, bringing most of their government risk exposures through state agencies as well as state guarantees under the formal fiscal framework. These two countries have assessed most of their outstanding government guarantees as risky and started to report their full values as

⁵ Separately, however, there remains the question of the agencies' own guarantees and other contingent liabilities.

government debt. Although this action has negatively affected their reported deficit and debt in the short term, it prevents most old contingent liabilities from complicating the future fiscal adjustment. This comes in contrast to the situation in other countries with a large portfolio of government guarantees, namely Cyprus, Malta and Poland.

Fiscal adjustment, and the associated focus of policy makers on reducing their deficits and debts in the short term has been known for making contingent forms of support attractive. In infrastructure, for instance, when government is concentrating on short-term control of the budget deficit and debt, it is more willing to encourage state-controlled financial institutions and nonstate parties to finance or operate facilities. Hence, private participation in infrastructure, rather than being a result of an effort to enhance efficiency, is sometimes associated with an effort to switch from explicit subsidies and capital expenditures (government direct obligations) to explicit or implicit guarantees (government contingent obligations). As many of the New Member States (specifically Cyprus, Czech Republic, Hungary, Malta, Poland, and Slovakia) face the need to undertake fiscal adjustment in the future that, perhaps with the exception of Slovakia, is complicated by the sharply rising fiscal cost of population aging, they may be tempted to alleviate the immediate budgetary pressures by switching to contingent form of government support.

It will be mainly a task for the domestic fiscal institutions to keep fiscal opportunism in check. By fully covering contingent liabilities in fiscal surveillance, the Commission may be able to motivate the correct use of contingent government support and deter excessive accumulation of contingent liabilities.

The following two sections in this paper discuss government fiscal risk arising from public-private partnerships in infrastructure and from local governments. The last section tackles domestic fiscal institution and the possible role of the Commission with respect to contingent liabilities.

Figure 1 The Current Contingent Liabilities and Fiscal Risk in the New Member States

	Direct Obligation in any event	Contingent Obligation if a particular event occurs
<p>Explicit</p> <p>Government liability created by a law or contract</p>	<p>Sovereign debt—loans contracted and securities issued by central government</p> <p>Cyprus, Malta and Poland (size and portfolio risk)</p> <p>Hungary (maturity risk)</p> <p>Czech Republic (interest rate risk)</p> <p>Future nondiscretionary budgetary spending, mainly social security and health</p> <p>Czech Republic, Malta and Slovenia (pension and health cost of ageing population)</p> <p>Poland (health cost of ageing population)</p> <p>Cyprus (pension cost of ageing population)</p> <p>Transition cost of on-going reforms</p> <p>Poland (public administration, health care and social security reforms)</p> <p>Lithuania (pension and health care reforms)</p> <p>Estonia, Hungary, Latvia and Slovakia (pension reform)</p> <p>Arrears</p> <p>Lithuania (arrears on VAT refunds)</p> <p>Tax expenditures like exemptions</p> <p>Poland (tax exemptions for state-owned companies)</p> <p>Spending commitments vis-à-vis the EU and NATO</p>	<p>State guarantees for borrowing of enterprises</p> <p>Czech Republic, Cyprus, Malta, Poland and Slovenia (credit guarantees mainly to state-controlled companies)</p> <p>Statutory guarantees on liabilities and other obligations of various entities, including financial institutions (state-owned banks, pension funds, infrastructure development funds, etc)</p> <p>Czech Republic (Czech Consolidation Agency, Ceska Inkasni, Czech Land Fund, Railway Transport Infrastructure Administration, Agriculture Guarantee and Credit Support Fund)</p> <p>Hungary (State Development Bank, EXIM Bank, Export Credit Insurance Company, Pension Reserve Fund to cover private pension annuity, Deposit Insurance Fund, Credit Guarantee Fund, Rural Credit Guarantee Foundation, Office of Agricultural Market Regime, and environment guarantees of the Privatization Agency)</p> <p>Estonia, Latvia, Lithuania, Poland and Slovakia (Guarantee/Reserve Funds and the related minimum pension/ relative rate of return guarantees, deposit guarantee, investor protection, and credit and export guarantees)</p> <p>State guarantees on service purchase contracts</p> <p>Poland (possible obligations arising from the past power-purchase agreements)</p> <p>Other state guarantees issued to private investors and service providers</p> <p>Hungary (guarantees related to the privatization of Postabank)</p> <p>State guarantees on debt and other obligations of local governments</p> <p>State insurance programs</p> <p>Litigation</p> <p>Poland (legal claims against the government with respect to weak copyright protection and 1944-1962 property losses)</p> <p>Lithuania (legal claims for savings compensation and real estate restitution)</p> <p>Slovakia (legal claims by CSOB and the Slovak Gas Company)</p>
<p>Implicit</p> <p>A “political” obligation of government that reflects public and interest-group pressures</p>	<p>Future recurrent costs of public investment projects</p>	<p>Claims by public sector entities to assist in covering their losses, arrears, deferred maintenance, debt and guarantees</p> <p>Poland (obligations of state-owned companies – some arising during the restructuring of railways and mines; obligations of hospitals and state agencies)</p> <p>Hungary and Malta (obligations of state-owned companies and the related cost of restructuring)</p> <p>Czech Republic (environment guarantees issued by the National Property Fund; losses, arrears and debt of the Czech Railways)</p> <p>Claims by local governments to assist in covering their own debt, guarantees, arrears, letters of comfort and similar</p> <p>Poland (local government debt and guarantees related to regional development)</p> <p>Lithuania (municipal budget arrears)</p> <p>Czech Republic (bail-outs related to hospital arrears)</p> <p>Claims by financial institutions, such as state-owned banks, social security funds, and credit and guarantee funds)</p> <p>Latvia (pension and social security funds)</p> <p>Slovenia (Small Business Development Fund, regional guarantee schemes)</p> <p>Non-contractual claims arising from private investment, for instance in infrastructure</p> <p>Hungary (possible claims arising from motorway construction concessions – partly implemented through the Road Construction Corporation of the State Development Bank)</p> <p>Poland (claims arising from expressway construction concessions)</p> <p>Other possible obligations, such as environment commitments for still unknown damages and nuclear and toxic waste</p> <p>Lithuania (decommissioning of the Ignalina nuclear power plant)</p> <p>Cyprus (reunification cost)</p>

Notes: 1) This matrix presents fiscal risks that face the central government (the fiscal authority rather than the consolidated public sector).
2) Countries listed are among those in which the respective source of risk has been significant. Not all entries in the table are, however, up to date and an update is forthcoming.

Source: Various sources. The framework is based on Polackova (1998).

Public Risk in Private Infrastructure

New Member States seek to reach beyond their available financial resources to close the existing infrastructure gap. Having approached the limits of their domestic financial sector and official development assistance, they have explored the experience of other countries in handing parts of infrastructure over to private finance. Here, I only consider the public (fiscal) aspects of this experience – mainly related to the fact that governments are under pressure that too little public support may dissuade private investors and adversely affect the government’s aims of attracting investment into the sector.⁶

Experience suggests that fiscal savings in private infrastructure are to be found in improvements in the efficiency with which the businesses are run or in the quality of public policy—not in transforming subsidies into contingent liabilities. Private investors frequently seek some form of financial support from host governments, to increase the project’s expected net cash flows and/or to reduce the variability of those cash flows (that is, to reduce risk). Upfront grants in cash or in kind, ongoing subsidies, and subsidized credit increase the project cash flows without necessarily altering its risk. Other forms of fiscal support also reduce investors’ or lenders’ risk exposure, including loans subordinated to other debt, minimum revenue guarantees, credit guarantees, and foreign exchange guarantees. It is these risk-reducing instruments of contingent government support that in due time generate unforeseen fiscal cost

Fiscal cost of government contingent support to infrastructure is not certain whether, when and in what amount to surface. The probability of the contingency occurring and the magnitude of the government outlay required to settle the ensuing obligation are typically difficult to forecast. Probability and magnitude may depend on some exogenous conditions (such as low demand for the services of a particular infrastructure project), including the occurrence of a particular event (for example, a natural disaster or debtor’s default). They may also depend on some endogenous conditions, such as government policies (an example being tariff policy and exchange rate

⁶ This section benefits from Brixi and Irwin (2004).

policy) and the design of government programs (an example being the distribution of risks under guarantee contracts to private providers of infrastructure), as well as on the quality and enforcement of regulations and supervision.

To complicate matters, the boundary between explicit and implicit government obligations in infrastructure is not always sharp. Since the provision of infrastructure services is often a politically sensitive issue, governments face pressure to ensure certain outcomes in service delivery and hence, if necessary, bear costs even when not legally obliged to do so. In the extreme, governments bail out infrastructure providers. Many countries around the world have seen large bail-outs of parties involved in infrastructure, including state-controlled banks and financial institutions, and local governments and state-controlled nonfinancial corporations (with respect to their debt, arrears, and other obligations as well as deferred maintenance and backlog of investment needs for asset renewal).

Contingent fiscal support to infrastructure often comes in the various forms. The state may issue various types of guarantees for private participation in infrastructure. Guarantees and other commitments are sometimes issued also by other parts of the government and public sector and as nonsovereign obligations these constitute an implicit rather explicit obligation for the central government. Local governments and state-controlled corporations issue guarantees, letters of comfort and other commitments to absorb credit risk or other types of risk. Although the legal implications such nonsovereign obligations may not be clear, they ultimately may create fiscal cost for the state. Nonsovereign obligations are generally not monitored and often not properly understood by their issuers.

Aside from the problem of ultimate fiscal cost, the effect of disguised subsidies on the future development in the infrastructure sectors may actually be negative. Disguised fiscal support that makes financing for infrastructure easy and cheap may mask the need for structural reforms in the infrastructure sectors. For projects that are commercially viable, such support may crowd out the private sector. Efficiency in infrastructure provision suffers in consequence.

Among the cases when private infrastructure projects introduce new hidden fiscal costs and risks, three cases can be distinguished. First, the case when the government bears policy risks relating to the project. Second, when the governments bear other (“nonpolicy”) risks. Third, when the government is the purchaser of the services under a long-term take-or-pay contract.

Policy risk is unpredictable variation in the value of a project that results from the unpredictability of government policy, where “policy” means all the rules the government imposes, in laws, regulations, and contracts and all the ways the government chooses to implement those rules in practice. Uncertainty about the prices the government will allow is usually a major cause of policy risk in most infrastructure projects. Other sources of policy risk are rules governing taxes, the quality or quantity of the output the firm must produce, and whether other firms may compete with it.⁷

Governments bear policy risk as a way of protecting a firm from risks to which it is vulnerable and which the government but not the firm cannot control. Exposing the firm to some policy risks greatly increases the risk premium demanded by the firm and has relatively little benefit. Exposing the government to risk, however, may encourage the government to maintain good policies.⁸ Overall, it can reduce the costs of the project.

Yet bearing policy risk does have a fiscal cost. There is always a chance that the government will want to change the policy to which it has committed itself and have to pay the firm to do so. For example, they may grant private infrastructure firm a monopoly and then decide that competition would be better.

In other cases, governments agree to bear **nonpolicy risks**, that is, risks over which they have little or no influence. Examples include risk arising from uncertainty about the costs of construction, future demand for the infrastructure project’s services, and the value of a freely floating local currency, and whether (for reasons unrelated to changes in policy)

⁷ In most private infrastructure projects in developing countries, governments bear at least some policy risks. The mechanism is usually a contract with the firm that gives the firm certain rights (as well as obligations). The contract may, for example, give the firm the right to charge prices determined by a formula. If the government subsequently prevents the firm from charging the price permitted by the contract, the government will, all else equal, have to compensate the firm.

⁸ More precisely, it encourages the government to maintain the policies offered to the investor unless the benefits of changing the policy exceed the costs the change imposes on the investor.

the firm will repay its debt. Governments can bear these risks by giving the firm construction-cost, revenue, exchange-rate, and debt-repayment guarantees, respectively.

Protecting the firm from nonpolicy risk reduces the price the firm needs to charge to be willing to undertake the project. Guarantees such as those just mentioned reduce investors' exposure to risk and lower the expected returns they demand. They also allow the firm to borrow more or at lower interest rates.

But bearing nonpolicy risk has a cost to government. And, in contrast to case of policy risk, the cost of bearing the risk is likely to be as high to the government as it is to the firm.

At other times, governments agree in advance to **purchase a given output of a private infrastructure project for an agreed price**. For example, the government might agree to make fixed "capacity" payments to an independent power producer every month for 20 years so long as the power plant is capable of producing power—the discounted sum of the payments equaling the cost of building and maintaining the plant. Similar deals are done in the water sector, where governments sometimes ask a firm to build a water or wastewater treatment plant, agreeing in advance to purchase the output on a take-or-pay basis.

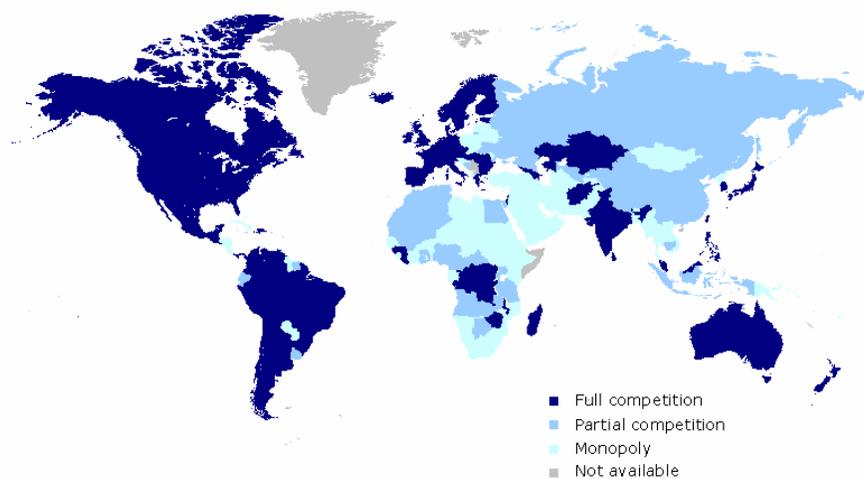
These obligations can be analyzed as the government's agreeing to bear policy and nonpolicy risks in the project. In contrast to the typical case in which the government agrees just to bear certain project risks, the (gross) cost of the government's obligation is likely to be roughly equal to the total cost of the project. Although the projects are usually described as private, they are in substance similar to public projects, in which the government contracts out construction and operation to a single firm.

Often governments don't enter into such agreements directly; instead, the contracts are signed by the electricity or water utilities that the government owns, often with a guarantee from the government that the utility will honor its purchase obligations. In estimating the total cost of obligations incurred in this way, the government might choose to "see through" the legal distinction between the government and the utility and consolidate the utility in its accounts, at least for analytical purposes if not in its financial statements. In this case, the government can treat the utility's purchase obligations as a

government liability and not separately count the cost of the guarantee. Alternatively, it may choose not to consolidate the utility and to consider its own obligation to be the purchase guarantee alone.

The pressures on governments to incur fiscal obligations in infrastructure industries are affected by **government policy toward competition and ownership** in these industries. The preservation of state-owned monopolies in infrastructure industries makes it hard, or impossible, for governments to avoid fiscal support for infrastructure. Progress on competition and ownership can facilitate progress on the fiscal side and, at the same time, changes in fiscal policy toward infrastructure can facilitate progress on competition and privatization. Although the problems occur in other industries as well, they are starkest in electricity. (Figure 2 illustrates the extent of competition in the New Member States in telecommunications.)

Figure 2 The Risk of Low Competition in the New Member States: Telecommunications



Source: International Telecommunication Union and World Bank staff

In seeking any reductions in fiscal cost of infrastructure, offering contingent support should come as the last option. The governments first needs to explore non-fiscal options, such as improving policies about ownership, competition, and regulation in infrastructure and improving the investment climate for all firms in the relevant localities and in the country as a whole. The government also needs to explore the option of not providing any fiscal support, or at least no fiscal support specific to infrastructure services. Finally, the transparency and simplicity of providing an explicit cash subsidy to the

infrastructure firm or its customers, or capital in the form of equity or debt, need to be weighed against the opacity and fiscal risks of contingent government support.⁹

As for EU fiscal surveillance, both explicit and implicit contingent government support associated with non-policy risk deserve attention – beyond the current regulation.¹⁰ Either directly or through a public utility, by signing a contract with an infrastructure firm giving it the right to charge certain prices, by covering the risks related to the construction-cost, exchange-rate, or the firm's future revenue and debt-repayment, and by entering long-term purchase contracts, the government may expose itself to significant fiscal risk.

Local Government Risk

Growing experience indicates that the central government (and the country's public finances) is at risk when local governments expose themselves to excessive fiscal risk. Local fiscal risk can be defined as a source of financial stress that could face a local government in the future. Similarly to central government, local governments can accumulate direct and contingent liabilities. The Fiscal Risk Matrix in Figure 3 gives a list of examples relevant for local governments.

The Fiscal Hedge Matrix (Figure 4) complements the Fiscal Risk Matrix to illustrate the different financial sources that can serve to cover local government obligations. Sources of local government financial safety can also be divided into direct and contingent, either explicit or implicit. Direct explicit sources reflect the local government's legal power to raise income from its existing, tangible assets. Direct implicit sources are also based on the existing assets, but these are not under the local government's

⁹ Giving the infrastructure firm or its customers an explicit cash subsidy is perhaps the simplest type of support. Not so common in the New Member States, the practice is widespread in Latin America, where many governments have awarded concessions to the bidder seeking the lowest cash subsidy or provided voucher-like subsidies to selected customers.

¹⁰ With respect to public-private partnerships, Eurostat, recommends that the assets and associated liabilities in a public-private partnership should be classified as not belonging to the government and therefore kept off the government's balance sheet, only if a) the private partner bears the construction risk and b) the private partner bears either availability or demand risk. If construction risk is borne by government, or if the private partner bears only the construction risk, the assets and liabilities are considered the government's (Eurostat 2004).

direct control and, thus, may offset fiscal risks to a limited degree only. Contingent explicit sources relate to the local government’s legal power to raise finances in the future from sources other than own assets. Finally, contingent implicit sources are not available to the local government until a particular situation occurs and even then, require the local government to make a special case for their utilization.

Figure 3 Fiscal Risk Matrix – Local Government Exposures

<i>Sources of Risk</i>	Direct Obligation in any event	Contingent Obligation only if a particular event occurs
Explicit Government liability as recognized by a law or contract	<ul style="list-style-type: none"> Local government debt (loans contracted and securities issued by the local government) Arrears in wage and benefit payments (if legal responsibility of the local government) Non-discretionary budgetary spending Expenditures legally binding in the long term (civil service salaries and pensions) 	<ul style="list-style-type: none"> Local government guarantees for debt and other obligations of public sector entities Local government guarantees for debt and other obligations of non-public sector entities Local government guarantees on private investments (infrastructure) Local government insurance (crop insurance)
Implicit A moral obligation of Government that reflects public and interest-group pressures	<ul style="list-style-type: none"> Remaining capital and future recurrent costs of public investment projects The cost of future benefits under the local social security schemes Future spending on public health and disease control and on goods and services that the local government is expected to deliver 	<ul style="list-style-type: none"> Claims related to local government letters of comfort Claims by failing financial institutions Claims by various entities to assist on their non-guaranteed debt, their own guarantees, arrears, letters of comfort and other possible obligations Claims related to enterprise restructuring and privatization Claims by beneficiaries of failed local pension fund, employment fund, or social security fund – beyond any guaranteed limits Claims related to local crisis management (public health, environment, disaster relief,...)

Notes: This matrix presents fiscal risks from the perspective of local (provincial, county, township or other local) government.
Source: The author. Based on a framework presented in Polackova (1998).

Figure 4 Fiscal Hedge Matrix – Local Government Sources of Financial Safety

<i>Sources of financial safety</i>	Direct Based on existing assets	Contingent Dependent on future events
Explicit Sources directly (legally) under local government control	<ul style="list-style-type: none"> Local government-owned assets available for possible sale or lease (own enterprises, land, other local public resources) 	<ul style="list-style-type: none"> Local tax revenues less tax expenditures Transfer income from the central government Recovery of loans made by the local government (on-lending)
Implicit Sources indirectly (not in legal terms) under local government control	<ul style="list-style-type: none"> Existing local funds - other than those under direct control of the local government (possibly local pension funds, local health funds) 	<ul style="list-style-type: none"> Future profits of enterprises and agencies under some local government control Contingent credit lines and financing commitments from official creditors to the local government

Note: This matrix presents sources of fiscal safety from the perspective of the local (provincial, county, township or other local) government.
Source: The author. Based on a framework presented in Bixi and Schick (2002)

The two matrices shown above outline the scope for local government fiscal analysis and fiscal management. The two matrices, in fact, represent an extended balance sheet of the local government. Compared to the standard balance sheet, the extended balance sheet provides invaluable information about contingent and direct implicit items that may affect local government future net worth.

Although one cannot always measure all of the items in the extended balance sheet, the approach is a useful way to think of which local government actions imply progress or regress toward local government long-term fiscal stability. Analyzing this broader notion of fiscal stability requires many assumptions to calculate concepts such as the local implicit pension debt and the value of local land. This kind of analysis would be illustrative of how the local government's long-term finances will evolve if certain assumptions hold.

In the New Member States, particularly in the context of regional development, local governments often need to take risk. To finance investments, local governments may need to borrow. In some instances, also local government support in the form of contingent liabilities may be justified. With respect to local enterprises in under privatization, for example, it may be acceptable that the local government protects the new enterprise owners against any possible environmental liabilities that had been incurred before the time of privatization but came to light only after.

Compared to the central government, however, fiscal discipline at the local level is undermined by the perception that the central government will ultimately bail out local governments in case of their insolvency.¹¹ This perception influences the behavior of both local government officials (who may tend to over-borrow, issue too many guarantees and letters of comfort, establish and provide backing to extensive local insurance programs, and take on financial risk through commercial activity) and the creditors (who may expose themselves to excessive credit risk vis-à-vis local governments either by lending to local governments or by recognizing local government guarantees, letters of comfort, and perceived backing).

Local policymakers also tend to build up government contingent liabilities to avoid difficult adjustment and painful structural reforms in their localities, and to escape fiscal discipline and control mechanisms (such as fiscal deficit targets and debt ceilings). In this process, raising funds through local government-controlled corporations substitutes direct government borrowing; credit guarantees issued by various entities that under local

¹¹ Rodden et al (2003) provide a set of country examples on the issues of soft budget constraint of local governments.

government control replace local budgetary subsidies; take-or-pay contracts come in lieu of investing public resources, liberalizing prices, and restructuring the energy, water, and other vital sectors; “letters of comfort” signed by local government officials allow insolvent enterprises and banks to access new credit and avoid bankruptcies; and so on.

The consequences may be costly. These mechanisms work for a limited period of time, longer in periods of economic prosperity and growth. But, ultimately, off-budget support may affect the local government budget and, can do so to an extent requiring financial intervention from the central government. The following section tackles this problem, as well as the problem of other contingent liabilities, from the angle of the domestic fiscal institutions and EU fiscal surveillance.

Dealing with Contingent Liabilities on the Road to EMU

This section discusses domestic fiscal institution and the possible role of the Commission with respect to contingent liabilities. Measures that can be implemented in the context of EU fiscal surveillance to promote appropriate incentives and capacities in dealing with contingent liabilities in countries are suggested.

1. Promote risk awareness.

An open discussion of risks and possible government risk exposures enhances government understanding of and dealing with contingent liabilities. Similarly, at the level of local governments, introducing an open discussion and acknowledgement of risks, their sources, types and possible fiscal implications may deliver significant benefits to the soundness of local government policies as well as their overall fiscal performance. Most New Member States have been trying to collect, analyze and discuss information about the risk exposures emerging from state guarantees. Few have introduced a discussion about the whole portfolio of contingent liabilities and fiscal risk.

The EU fiscal surveillance process could involve fiscal risk analysis and discussions with government officials that go beyond the government’s own official statements. In the context of fiscal surveillance, it may be valuable to develop a survey of risk exposures of local governments, risks arising in the infrastructure sectors, and risk

exposures of state-controlled and strategically important companies, especially major suppliers of vital services and various risk-prone financial institutions, such as credit and guarantee funds. Such survey may be able to promote the government's own understanding of its own contingent liabilities and related fiscal risk.

2. Reward disclosure. Punish opacity and excess.

Disclosure benefits scrutiny, fiscal discipline and contestability of resources. Information that is disclosed invites scrutiny by people outside the government and by the government itself. When disclosure rules have broad coverage, they enable the government at its different levels to improve its monitoring of lower-level governments and public sector units, and expand the share of government activities that is open to public scrutiny. Scrutiny is likely to generate pressure for greater discipline—applied by, as well as on, the local governments.

Modern financial-reporting standards require the disclosure of commitments, contingent liabilities, and certain other sources of financial risk. So adopting such a standard automatically creates a requirement to disclose information about hidden borrowing and hidden subsidies. And it automatically creates a mechanism for enforcing disclosure, since the government's auditor must express an opinion on the accuracy of the disclosures.

Disclosure should not be constrained by the weaknesses in the existing financial-reporting standards or by slow progress in their improvement. Improvements in standards governing government financial reporting and accounting may deliver many benefits, including improvements in disclosure. But promoting disclosure should not be held hostage to the improvements of these standards. Statements of risk, for instance, can complement any financial statement or report. At the level of central government, Australia, Canada, Czech Republic, Netherlands, New Zealand, United Kingdom, and the United States offer some good practice to consider. In these countries, the government publishes a list of the various sources of its risk exposures, talks about the nature, sensitivities, and possible financial and allocative implications of the risks. The statement can provide an estimate of the possible future fiscal cost associated with an item on the list. Such information sometimes comes in a separate statement of contingent liabilities,

statement of commitments (including long-term purchase or subsidy contracts), or an analytical report on fiscal risk disseminated as one of the budgetary documents.

Local government statements of risk can complement their existing reports that are made public or submitted to a higher level government. These statements can discuss local government guarantees, letters of comfort and other explicit contingent liabilities, local government commitments, the limits of local government responsibility vis-à-vis own implicit contingent liabilities, and activities of local government-controlled financial and non-financial enterprises. Among local governments, Australia's State of Victoria, Canada's Ontario Province, India's State Tripura, and United Kingdom's England and Wales offer aspects of good practice.

There are several prerequisites for disclosure as well as adequate risk awareness at both the central and local government level. These include: a database of the respective government's direct and contingent obligations to form a basis for analysis; an adequate institutional capacity, including the capacity to gather and analyze relevant information and evaluate risk exposures; and for internal disclosure, an adequate enforcement mechanism, including supportive political and legal environment (for instance, with respect to local government reporting on their direct and contingent obligations to the central government) to ensure compliance. For public disclosure, local governments may agree (or the central government may need to issue rules) regarding the format in which to make the information public. Local grassroots agencies, investors and local public pressure may be effective in monitoring local government performance, including risk exposures and their disclosure.

In addition to disclosing their own risk exposure, the central and local governments need to promote disclosure in the public sector and the economy at large. Again, these efforts should relate to but not be constrained by the status and progress of financial-reporting standards in the public sector and in the domestic market.

The most vital contribution that fiscal surveillance could make to further promote disclosure in New Member States is to reward it. Countries that voluntarily expose the full scale of their contingent liabilities and fiscal risk, for instance, should be, first of all, publicly commended. In such instances, the positive value of transparency should be

weighed carefully against the negative value of the revealed risks. That is to say that perhaps a country deserves an “upgrade” for transparency rather than a “downgrade” for additional risks that have been revealed. Furthermore, the Commission can be instrumental in arranging for further assistance in building the countries’ capacities for disclosure discussed above.

On the other hand, fiscal surveillance could involve punishment for opacity and for excessive risk taking. For instance, countries could be punished if explicit contingent liabilities that had not been earlier admitted by the government surfaced by way of falling due; or if implicit contingent liabilities that had been known to but not admitted by the government realized. A punishment in the form of public statement of disappointment would be easy to implement. Another, more difficult but more effective option would be for the Commission to require the respective government to build a contingent-liability fund. (Issues associated with contingency reserve funds are discussed below.) This would be particularly important for countries exposed to excessive fiscal risk. In this regard, the Commission could seek to set rules on government risk exposure, and establish a set of fiscal risk warning indicators.

3. Assist in accounting and budgeting reforms.

Accounting and budgeting rules influence the allocation of resources, they affect the timing and recognition of transactions, and may provide opportunities and incentives to shift costs and risks from one period to another and from one part of a government (or of the public sector) to another. Cash flow budgeting, which is implemented in most New Member States, makes guarantees, take-or-pay contracts and purchase of infrastructure services from private providers look more attractive than cash subsidies and publicly financed projects. It treats subsidies and publicly financed projects as outlays, but does not recognize contingent liabilities until default occurs, at which point the government has little choice but to make good on past commitments. Publicly financed projects and subsidies thus appear expensive, and contingent form of support cheap. To make matters worse, in cash flow accounting and budgeting, any income earned from origination fees on guarantees is booked as current revenue, making it appear that government is profiting by taking these risks irrespective of the cost.

An accrual-based accounting and budgeting system requires many noncash costs to be included in budgets and thus made visible from the moment government decides to incur them. As for contingent liabilities, accrual-based budgeting and financial reporting can help to reveal and confront policymakers with the costs of guarantees and long-term purchase contracts. As discussed under disclosure, accrual-based standard can require the disclosure of information about contingent liabilities created by guarantees and commitments created by long-term purchase contracts. How well the accrual-based budgets and financial reports reflect costs, however, depends on the particular standards that are applied and how well they are enforced.

Accrual-based standards are helpful, but neither sufficient nor necessary for solving all the problems. Accrual-accounting standards do not cause all costs and all liabilities to be revealed. They do not necessarily require the costs of guarantees to be included in calculations of budget deficits. And they do not necessarily require the liabilities created by long-term purchase agreements to be recognized alongside ordinary debts on the balance sheet. The leading international standards appear to be improving: International Financial Reporting Standards, International Public Sector Accounting Standards (which modify International Financial Reporting Standards for use by governments), and generally accepted accounting principles in the United States, for example, all appear to be converging toward more accurate accounting for such instruments. According to each of these three sets of standards, many guarantees would be recognized at their fair value, while the value of most others would at least be disclosed. It will likely be some time, however, before the standards require a fully satisfactory approach.¹² Moreover, while adopting accrual standards can help address the problems, the problems can also be addressed without adopting such standards.

In government budgeting, contemporary approaches reflect two important principles for budgeting for fiscal risk.¹³

¹² Irwin (2003b). In addition, there are various rules that can be helpful in regard to government risk exposure. For instance, according to the IMF, nonfinancial public enterprises that are not commercially run should be included in fiscal statistics (IMF, 2004).

¹³ Brixi and Schick (2002)

- Apply a joint ceiling to the cost of budgetary and off-budget support for each sector in a fiscal year. Off-budget support is considered a form of subsidy and thus subject to the same scrutiny and limits as any spending program. The size of the hidden subsidy is calculated as the present value of the future expected fiscal cost.
- Have the budget reflect the full likely fiscal cost of contingent support immediately when a contingent support scheme is approved.

Another, possibly complementary, option is to create a contingent-liability fund. Some governments have created a special fund (a new bank account in other words) that is used to meet calls on guarantees and other liabilities. When guarantees are issued, the sector ministry can be required to transfer to the fund an amount equal to the estimated value of the guarantee. In Canada and Netherlands, which follow the two principles above as well as use a special fund, for example, the finance ministry computes the expected annual payout on contingent liabilities undertaken on behalf of programs of each line ministry. The finance ministry then deducts these expected payouts from the annual budgetary allocation for the ministry concerned. Similar arrangements, including mechanisms to provide reimbursement to the line ministry for such provisions if a payout on the contingent liability does not occur ex post, has been also tried in Colombia.

These principles have several important implications on government fiscal performance. Budgeting for risk may or may not affect cash-based estimates of the government's fiscal deficit. It depends on whether the effect on the deficit is recorded when money is transferred from the budget to a contingency fund (then no effect is recorded when a guarantee is called and paid for from the contingency fund) or only when actual cash payments are disbursed from the program account. But budgeting for risk makes policymakers more cash neutral, that is neutral between alternative forms of providing government support from the viewpoint of deficit measurement, budget ceilings, or medium-term fiscal outlook. And, most importantly, perhaps, budgeting for risk promotes risk awareness among policymakers.

Experience suggests that the benefits of greater scrutiny, cash-neutrality, and risk awareness can be achieved with or without a comprehensive transition of the accounting and budgeting systems to the accrual basis. Countries that have successfully combined

reporting of contingent liabilities (and wider disclosure of risk) with cash accounting include the Czech Republic and South Africa, and those budgeting for risk within a cash-based budgeting system include the Canada, Colombia, Netherlands, and the United States. Similarly, fiscal risk can be brought into the government's medium-term budgetary framework. Setting the government budget and risk exposures in context of a publicly announced medium-term budgetary framework, which would later make any departures from the original risk analysis apparent has already strengthened accountability of policymakers and the quality of fiscal policy in many countries, including Australia (including New South Wales at the local level), Canada (including British Columbia and Ontario at the local level), Hungary and South Africa.

In New Member States, the inclusion of contingent liabilities in fiscal surveillance could encourage further reforms of the accounting and budgeting reforms. These would benefit from further technical assistance. It could also assist in broadening the scope of the annual budget process to involve any major questions related to government risk exposures so that it provides an effective platform for an open discussion of policy choices.

4. Assist in fiscal risk management.

Experience of governments trying to actively manage their risk exposures shows that fiscal risk management is very demanding. Governments find that to manage their risk exposures, they need: adequate information – hence a comprehensive database of all major risk exposures, capacity to gather relevant information, and open discussion, among others; ability to understand – which may be assisted by useful analytical frameworks; and incentives to act correctly – which are supported by disclosure and adequate accounting and budgeting rules discussed above.

Proper incentives in dealing with local government risk are supported by appropriate accountability structures. Policymakers need to be accountable for adequacy of their risk analysis, assumptions and decisions that involve fiscal risks, and for managing the overall government risk exposure. Therefore, the role of the supreme audit institution (and the local audit bureaus) would be to audit all aspects of government risk analysis and risk management.

Practice has shown the importance of three additional features of risk management: a clear risk management strategy (to specify to what extent is the government prepared to take on fiscal risk), centralized risk-taking authority (possibly in the budget office of the ministry of finance), and risk monitoring separate from risk taking (possibly, the debt management office and the supreme audit institution could be responsible for monitoring risk internally and externally, respectively). The division of responsibilities and functions in risk management, and the underlying reporting arrangements, need to be very clear to provide a basis for adequate accountability structures.

For fiscal risk monitoring to be effective it needs to be comprehensive in its scope. Specifically, it needs to cover the whole range of channels through which governments at the local as well as central level generate fiscal risks, including letters of comfort, credit and guarantee funds, development corporations, local government controlled enterprises, and so on.

Among government agencies and departments, the government debt-management office is often most able to analyze and manage government risk exposures. Specifically, the debt-management office is often best equipped to gather and analyze information about government contingent liabilities, evaluate government risk exposure and future possible implications of contingent liabilities on government debt, reflect on the analysis of contingent liabilities in borrowing and debt-management strategy and advise the government on future possible fiscal cost of newly proposed programs and on how to structure these programs to reduce government risk exposure. Debt-management agencies are likely also to be in a good position to understand off-balance-sheet debt in the form of long-term purchase agreements. Debt-management offices have become in charge of risk analysis and management in a number of countries, most notably in Sweden.

In New Member States, fiscal surveillance could be linked to assistance in government fiscal risk management.

5. Assist in reducing government risk exposure.

Reducing government risk exposure entails three complementary tasks. These include: involving the private sector, transferring the risk to parties better able to bear the risk, and managing any residual risk that cannot be mitigated or transferred.

Involving the private sector mainly implies mitigating the risk at source and developing the financial markets. Ultimately, risk mitigation with private sector involvement is the most desirable long-run strategy since it not only reduces the government's exposure to fiscal risks but also reduces vulnerability of the economy to shocks.¹⁴

Risk transfer mainly implies creating risk-sharing arrangements. Creating a good risk-sharing mechanism requires clear policy objectives and understanding of all the underlying risks in a project. For both central and local governments, so far, the primary method of transferring risk has been through risk-sharing provisions in their guarantee and insurance contracts. In private infrastructure, recent practice has suggested that carving out commercial risk from the coverage of government guarantees reduces moral hazard under the project as well as limits government risk exposure.

Residual risk can sometimes be hedged. The private sector and, for some risks, international financial institutions, offer useful risk-mitigation tools. Governments and public-sector entities, for instance, sometime use currency swaps and commodity futures to hedge their foreign-exchange and commodity-price risks. They have also purchased reinsurance for disaster risk and weather risk from large international reinsurers. Increasing integration and liberalization in the market for insurance has made it easier to pool risk across countries and, increasingly, to insure risks until recently considered uninsurable. Governments might use some of these tools to hedge their exposure to risks in infrastructure projects. For the largest projects exposed to the catastrophic risk, governments might also be able to issue catastrophe bonds, which offer lower yields when a catastrophe occurs. Given the still nascent stages of the international catastrophe bond

¹⁴ In infrastructure, policymakers may need to ask how to reduce the dependence of private providers and investors on government guarantees and other kinds of support. Country-wide legal, regulatory and administrative changes and proper debt management strategy can facilitate the establishment of an efficient domestic bond market, which in turn will smooth the progress of private infrastructure as well as improve the government's capacity to absorb risk. Private investors and providers in infrastructure may also be more willing to forego government guarantees when the investment climate in the country improves. Regulatory changes can encourage large international insurers to access the local market and pool risks, such as weather risk, uninsurable in a small economy. New financial instruments, such as asset-backed securities or catastrophe bonds, may help domestic financial institutions to better manage risk, thus reducing their demand for government guarantees. Strategies to promote risk mitigation and financial market development, however, often hinge upon fundamental sectoral reforms, such as reforms in energy pricing, production and distribution systems.

market and weaknesses in the derivatives market, however, it is likely that governments will be able to reduce their risk exposure more effectively by first focusing policies to mitigate the risk at source and develop the domestic financial markets discussed above.

Risks that cannot be avoided or hedged must be absorbed, requiring the government to manage its financial assets so that it has cash when it needs it. If the government cannot avoid bearing a risk and cannot hedge the risk, it has no choice but to absorb the risk: that is, bear any losses and—depending on the nature of the contracts it has written—reap any gains. It must therefore have sufficient cash on hand to enable it to make payments when they fall due. It can aim to do this in three ways: Put cash in a contingent-liability fund (as discussed above) and hope the funds are sufficient to meet future payments. Or, use the cash to reduce debt and hope it can use tax revenues or additional borrowing if and when it needs to make payments. Or, enter into a standby credit agreement with a bank that will allow it to borrow if it needs to make payments.

Each option has advantages and disadvantages. Having cash in a fund may give the government stronger assurance that cash will be available when needed. But it also has a cost, because the cash could otherwise be used to repay debt or invest in public services. Using the cash to repay debt may be cheaper, but leaves open the question of whether the government will be able to borrow or raise taxes when liabilities fall due—possibly at a time of crisis. A standby credit agreement, if available, solves the last problem, but at a cost that may be high.

The options are not mutually exclusive. A government can, and may indeed have to, use more than one option. The contingent-liability fund, for example, cannot cover all contingencies. Even if the fund has the limited purpose of meeting calls on guarantees, it will be large enough to meet the worst possible losses only if the contributions are set according to the face value of the guarantees, and not according to their expected costs. If contributions are smaller, the fund has to be combined with possible reliance on taxing and borrowing or on a standby credit agreement.

The existence of cash in a fund may also tempt the government to use the money for other purposes. One option around this is to contract out management to a reputable foreign entity. The contract could specify permissible reasons for withdrawing cash from

the fund without penalty and make other claims subject to a penalty and prior public disclosure.

The discussion above indicates that reducing government risk exposures, as well as the overall dealing with contingent liabilities and fiscal risk, is relatively complex and difficult for policymakers to address. Therefore, New Member States would benefit from continuing technical assistance in these areas. Such assistance would perhaps be most effective if linked to the fiscal surveillance process.

Concluding Remarks

Fiscal surveillance needs to cover contingent liabilities in order to promote appropriate disclosure and dealing with contingent liabilities in New Member States. This paper suggests that whether or not there is a large amount of contingent liabilities outstanding in New Member States, their existing economic and fiscal characteristics generate a possibility for contingent liabilities to grow in the future.

The fiscal surveillance process can aim at strengthening the incentives in New Member States to disclose and manage contingent liabilities well. To do so, fiscal surveillance could link to appropriate technical assistance programs, and become a vehicle to reward fiscal transparency and punish opacity and excessive risk taking.

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